# Global Fixed Income Strategy

Monthly report

**Invesco Fixed Income**

August 30, 2024

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Global macro strategy

## Message from Jackson Hole: It's time to cut

Federal Reserve Chair Powell's much-anticipated speech at the Jackson Hole Symposium had a clear message: the time for rate cuts has arrived. This message was expected, as several Federal Open Market Committee (FOMC) members have expressed similar views, signaling a broad consensus that rate cuts are on the horizon. Powell spent much of his speech discussing inflation developments over the past few years — his interpretation of how it rose and how it has been coming down. His conclusion is that inflation is on a path to the Fed's price stability objective on a sustainable basis, and there is confidence in this progress — it is time to cut rates. However, Powell was noncommittal on the magnitude and pace of cuts. He doesn't need to be at this point; there is time for more data to come in, and markets are stable. The pace of the cutting cycle will depend on incoming data, how the Fed views the outlook, and risk factors. In the following sections, we discuss our near-term outlook for the US economy and our expectations for the Fed's upcoming actions.

### US economy is resilient and growing around its potential rate, which is approximately 2%

While there is talk of a slowdown, this might give the impression that growth is slow, which is not the case. Growth was strong in the second half of last year, averaging just over 4% annualized — well above the economy's potential growth rate.[1] Given such a strong base, a slight slowdown is expected and should not be a cause for concern. We believe a more reliable way to measure underlying economic growth is to focus on domestic private demand, which excludes volatile components like inventories and exports. Domestic private demand, comprising consumption and investment, provides a clearer picture of the economy's core strength than overall GDP. This measure has been growing steadily, at 2.6% in the first half, aligning well with the historical median.[2] Growth around potential is our current baseline expectation for the rest of the year.

### While growth has been stable, the labor market has been cooling, shifting the balance of risks in the economy

A key data point in the most recent jobs report was the increase in the unemployment rate, which historically tends to lead to further weakening at current levels of change, known as the Sahm rule. This development is worth monitoring and raises risks in the economy, but it is important not to take a historical empirical regularity as a hard rule. Economic cycles have commonalities, but they are not all the same.

The current cycle is unique, having been triggered by the pandemic rather than the usual economic and financial factors. The recent increase in the unemployment rate is mainly due to increased labor supply, thanks to increased participation and immigration. There has been continued net job creation, as reported in the Bureau of Labor Statistics (BLS) establishment survey. Labor demand has softened but it is still solid, and layoffs are at low levels. And data released since the jobs report have been less worrisome. Initial jobless claims have stabilized. Retail

1. Source: Bureau of Economic Analysis. Data as of July 25, 2024.
2. Source: Bureau of Economic Analysis. Data as of July 25, 2024.

sales numbers have shown stability in consumer spending. On net, while the latest BLS report raised eyebrows about the sustainability of the expansion, the totality of the data does not suggest a turning point.

The August BLS jobs report, set to be released on September 6, is the most critical data point ahead of the next FOMC meeting. Markets will likely monitor well-known variables, including the change in nonfarm payrolls and the unemployment rate. A central focus of this report will be to determine whether the weakness observed in July was a one-off event, influenced by weather effects and typical monthly volatility, or if it indicates a more concerning trend of weakening.

Beyond these headline figures, it is essential to delve into the report's details to assess whether a turning point in the labor market is approaching. For instance, examining labor market flows will help determine the source of the increase in unemployment — whether it is driven by new entrants into the labor force, as a result of immigration and increased participation, or by those that are currently employed. The latter scenario often signals a turning point. Additionally, attention will likely be given to indicators, such as the breadth of job creation and hours worked, to gain a comprehensive understanding of the labor market's underlying dynamics.

The increase in the unemployment rate has shifted the balance of risks, regardless of whether this marks a turning point in the labor market. An increase in labor supply indicates that more people are willing to work but are unable to find jobs quickly enough. It suggests that the potential growth rate of the economy is higher than usual, slack is emerging, and monetary policy may be too tight for the current state of the economy. The current policy rate was set during a period when the labor market was tight, and inflation was elevated. But inflation is currently declining, while the unemployment rate is rising. Given the Fed's dual mandate of price stability and maximum employment, it is now time to adjust policy to reflect the current economic conditions.

## With Fed cuts, financial conditions should ease further, helping growth.

While Fed cuts are priced in — perhaps more than what we expect — we believe there is room for financial conditions to ease further.

Financial conditions have already eased based on standard measures, such as the Chicago Fed or Goldman Sachs indices, which are weighted averages of interest rates, asset prices and spreads. However, there is more to consider when assessing financial conditions. Bank lending conditions remain tight, and loan growth has been slow, below the typical growth rates seen during expansions.

Looking ahead, we expect this to change. Loan volumes are beginning to grow. According to the Senior Loan Officer Opinion Survey, banks are still tightening lending conditions, but the pace has slowed. Based on historical experience, this trend could shift toward easing by the end of the year. Meanwhile, loan demand is recovering, and with pending rate cuts, banks may accelerate loan growth.

## The Fed

The baseline scenario of a soft landing, growth at potential and expected easing in financial conditions, along with inflation not yet at target, suggest that the Fed will likely proceed cautiously. After a series of cuts this year to reduce recession risks — call them "maintenance cuts" — the Fed will likely continue to cut at every other meeting next year, i.e., meetings with a Summary of Economic Projections, until it reaches the terminal rate, which we currently estimate will be in the 3.00% – 3.25% range.

The risk scenario is further labor market weakness in the August jobs report, which could prompt the Fed to start with 50 basis point cuts. We believe this risk is declining, but the market will likely remain uncertain until the August employment report is released on September 6.

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Source for all data: Bloomberg L.P. Data as of Aug. 27, 2024.

# Interest rate outlook

**US: Neutral.** We favor a neutral position in US Treasuries. Growth and inflation have slowed, as we anticipated earlier this year. And the Fed has acknowledged that the employment side of its mandate faces increased risks. However, we believe the market is pricing in a too aggressive path for rate cuts in the near term. We believe that the Fed will only deliver three cuts this year, which is fewer than the market has priced in. This leads us to favor neutral pricing in US interest rates.

**Europe: Neutral.** We have moved tactically to a neutral position in Europe following the recent rally in global rates. However, over the medium term, we expect yields to fall further and would likely use any backup in rates in September to move overweight again. The improvement in growth earlier in the year has petered out and economic indicators now point toward stagnation in the region. Manufacturing remains very challenged as weak global markets and volatile energy prices keep activity muted. The consumer remains key to growth, but, despite a very strong labor market, households appear reluctant to draw down savings. For the European Central Bank (ECB), the challenge is to balance the short-term elevated level of inflation with the weak outlook. We expect the ECB to reduce interest rates two additional times this year, in line with market expectations, but we expect many more cuts next year, as inflation falls below the ECB's target.

**China: Neutral.** We expect the Chinese onshore interest rate environment to remain accommodative in the near and medium term and we expect curve steepening, as we expect short-term rates to outperform long-term rates. Of note are various news reports on regulatory measures to limit further downward moves in long-term bond yields, which is in line with potential curve steepening. We expect more proactive guidance from the central bank through its open market operations rate setting and window guidance for the long-term part of the bond market. Further room for downward yield moves is likely to be influenced by the US rate cutting cycle, the US presidential election and trade and financial policies under the new administration, given their ramifications for the US dollar/renminbi exchange rate.

**Japan: Underweight.** 10-year Japanese government bond (JGB) yields have fallen over 20 basis points since their peak in early July, mirroring the decline in yields elsewhere. However, unlike elsewhere, recent Japanese economic activity data have picked up, wage growth is running at multi-decade highs and near-term sequential inflation momentum is showing some signs of reacceleration. The Bank of Japan (BoJ) continues to signal that policy is accommodative and that normalization of interest rates toward neutral is consistent with its forecasts. This would imply real rates of approximately -1% to 0%, relative to close to -2% currently. The BoJ has also set out a plan to shrink its JGB purchases at a pace of 400 billion yen per quarter to Q1 2026, reducing its stock of holdings by approximately 7-8%. Significantly, the reduction in purchases is focused on sub-10 year maturities, which combined with future interest rate hikes, should lead to higher yields and a flatter JGB yield curve.

**UK: Neutral.** UK gilt yields have declined in the past month, helped the Bank of England (BoE) cutting rates by 25 basis points to 5% at the August meeting. However, gilts have underperformed US Treasuries and German bunds. Concerns about fiscal slippage, leading to greater gilt supply, and the perception that sticky UK inflation will mean the BoE will lag the Fed and ECB in cutting rates are some reasons for the underperformance. UK market pricing looks relatively fair on an absolute basis, in our view, with the market pricing a terminal rate just below 3.5%. However, the underperformance relative to US Treasuries and bunds now looks relatively extended, particularly as inflation dynamics in the UK are increasingly converging with other developed market peers.

**Australia: Neutral.** The weaker than expected Q2 inflation release has quashed near-term speculation about whether the Reserve Bank of Australia (RBA) would hike rates. But the RBA is signalling that it remains focused on upside inflation risks and will therefore maintain the current policy setting for some time. This is likely to cause Australia to lag the US, eurozone, UK, Canada and New Zealand in easing policy. This is already somewhat reflected in market pricing, with only 27 basis points of cuts priced in from the RBA, versus close to 100 basis points from the Fed in 2024. While front-end Australian pricing might be vulnerable to a hawkish RBA keeping policy higher for longer than other central banks, Australian long forward rates remain relatively elevated compared to other developed market peers. This should bias the yield curve toward flattening on both an outright and relative basis to other developed market yield curves.

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# Currency outlook

**USD: Underweight.** The key drivers of US dollar strength in recent years, such as strong growth relative to other economies and high interest rates, are beginning to wane, and, as such, we expect the US dollar to decline in the medium term. As the Fed begins to lower rates in the coming months, and potentially by more than the market anticipates over the next few years, we expect US dollar weakness to be broad based, especially against Asian currencies that have been trading at multi-decade lows. One caveat is that the US presidential election will likely be pivotal to the outlook for 2025. If we see an environment of lower taxes, lighter regulations and widespread trade tariffs post the election, this could reignite US growth and the weakness we expect in the coming months might be short lived.

**EUR: Neutral.** Despite the challenges faced by the euro area, we expect the euro to hold its ground versus the US dollar, as the Fed embarks on a rate cutting cycle while the ECB will likely be slow to lower rates. The euro may struggle against other currencies, however, while growth remains anaemic and political pressures over sovereign budget deficits intensify over the coming months.

**RMB: Overweight.** We have upgraded our position on the renminbi to overweight from neutral, as we expect the currency to show resilience compared to peers amid market volatility, as demonstrated by early August market moves. This upgrade is also against the background of changing interest rate paths in the US and China, as the US enters into a rate-cutting cycle and China limits further downward yield moves. We do note a below-average conversion rate of Chinese exporters' trade surplus, which may open the door to a catch-up if exporter sentiment shifts.

**JPY: Neutral.** The yen has appreciated by around 6% against the US dollar over the past month. The Fed's increasing focus on supporting the US labor market, combined with the BoJ's determination to continue with its policy normalization, should narrow interest rate differentials going forward, placing downward pressure on the USD/JPY exchange rate. However, a major yen appreciation will likely require a US recession and a shift of Fed policy from normalization to a shift to below-neutral interest rates, which the Fed currently defines as 2.75%. This sort of policy shift is unlikely to occur without a significant deterioration in US growth momentum toward a more recessionary situation. Hedge fund and commodity trading advisor (CTA) yen short positions have now been squeezed, but there is little evidence yet that Japanese investors are repatriating funds or raising currency hedge ratios. If the US yield curve steepens and Fed cuts accelerate, this will likely become an important factor, potentially driving a further leg of yen appreciation.

**GBP: Underweight.** Relatively resilient domestic data and widening interest rate differentials, driven by the dovish Fed, have supported the British pound, particularly versus the US dollar. However, it is hard to see the pound's sustained outperformance in the future, as valuations look relatively rich, particularly on a trade-weighted basis, and the BoE is unlikely to lag other central banks in cutting rates, to the extent the pound becomes an attractive carry play. Long-term fiscal austerity and the lagged impact of rate hikes will likely continue to weigh on UK growth, likely leading to easier monetary policy, which in turn will likely be a headwind for the pound's outperformance.

**AUD: Neutral.** The imminent Fed rate cutting cycle should bias interest rate differentials between the US and Australia to converge going forward, supporting the Australian dollar. However, this is already well priced, with US rates now projected by the market to be below Australian rates by late 2025. In addition, China's growth prospects, and the related performance of commodity prices, remain soft, posing a major headwind to sustained Australian dollar outperformance. Higher commodity prices, better risk sentiment and a narrowing interest rate differential with the US will likely be needed to drive significant Australian dollar outperformance going forward.

Source for all data: Bloomberg L.P. Data as of Aug. 27, 2024.

**Paul English**
Head of US Investment Grade Research

This section highlights the views of Invesco Fixed Income's credit analysts across a broad range of fixed income assets managed by Invesco.

Global credit strategy

# US Q2 earnings season better than expected

## Solid second quarter results

With over 90% of the Standard and Poor's 500 Index (S&P 500) having reported second quarter 2024 results, the revenue and earnings performance of S&P 500 companies in aggregate is running slightly ahead of expectations. The percentage of S&P 500 companies reporting favorable earnings surprises is above longer-term averages, though by a magnitude below average levels. Despite this, the S&P 500 Index is reporting its highest year-over-year earnings growth rate since the fourth quarter of 2021. Of these companies, 79% have reported actual earnings per share (EPS) above estimates, which is above the five-year average of 77% and above the 10-year average of 74%, according to Factset.

The blended earnings growth rate (combining actual results for companies that have reported and estimated results for companies that have yet to report) for the second quarter is 8.5%, as of the end of the second quarter (June 30), according to Factset.

In aggregate, companies are reporting earnings that are 4.5% above estimates, which is below the five-year average of 8.6% and below the 10-year average of 6.8%. Most recently, positive EPS surprises reported by three large technology related companies were the largest contributors to the increase in overall earnings growth. Sectors with elevated earnings growth included Healthcare, Consumer Discretionary and Utilities, while Materials, Industrials and Consumer Staples produced the weakest earnings growth.

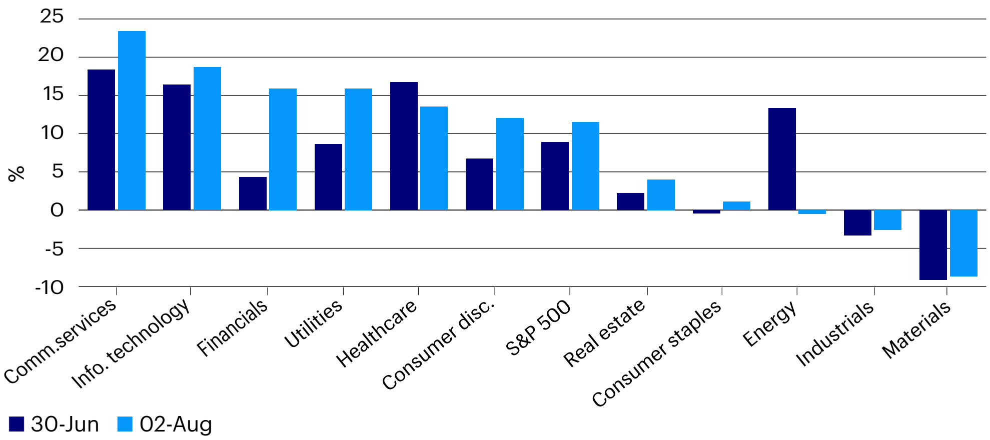
Second quarter S&P500 revenue growth of 4.8% was notably below the earnings growth trajectory. Revenue growth was highest in the Energy, Healthcare and Technology sectors, while Materials, Industrials and Consumer Staples produced the weakest revenue growth.

## Looking ahead

In terms of forward guidance, 74 companies in the index have issued EPS guidance for Q3 2024 according to Factset. Of these 74 companies, 39 have issued negative EPS guidance and 35 have issued positive EPS guidance. The percentage of companies issuing negative EPS guidance for Q3 2024 is 53% (39 out of 74), which is below the five-year average of 59% and below the 10-year average of 63%.

Taking the revenue and earnings data in tandem with management commentary, we continue to believe that companies remain in good financial position, have managed margins effectively and can handle pockets of weakness that include low-income consumer spending and larger ticket discretionary items. Technology related capital expenditures remain robust and most financial institutions are reporting solid results, despite slowly deteriorating consumer credit performance. We remain watchful of employment trends, Federal Reserve policy and potential changes in corporate and consumer spending.

**Figure 1: US investment grade earnings growth – Q2 2024**




Source: Factset. Data as of Aug. 2, 2024. Figures represent blended results (75%/25% reported/remaining estimates).

Source for all data: Bloomberg L.P., Factset. Data as of Aug. 19, 2024.

**Panelists**

**Matt Brill**
Head of North America Investment Grade

**Todd Schomberg**
Senior Portfolio Manager

## The bottom line: Beyond August volatility: Invesco portfolio managers share their views

In August, markets experienced a surge in volatility as Treasury yields declined and credit spreads widened in response to a series of adverse economic events — including disappointing jobs data. However, stability has since returned, as credit spreads have narrowed, and Treasury yields have recovered from their year-to-date lows. Investors appear to have reassessed the situation, recognizing that the early-August volatility may have stemmed from a market overreaction after anticipating a flawless economic outcome. In a discussion with Invesco portfolio managers Matt Brill and Todd Schomberg, we explore the factors behind this volatility and their perspective on the investment grade bond market going forward.

**Q: What drove the volatility that surprised markets in early August?**

**Matt:** The equity and bond market volatility that started the month was centered around three things, in our view. First, as we've been stating for a while, the Fed has switched its attention solely from inflation to inflation and growth, and growth has been more challenged lately.

The Fed now seems more confident that it has gotten inflation under control. And while there have been some signs that lower income consumers have been struggling, growth, while slowing, has been resilient. Nevertheless, the July employment report showed a shortfall in the number of jobs created versus expectations, with 114 thousand jobs created versus around 170 thousand expected.[3] The unemployment rate also rose and markets worried that the Fed was behind the curve in terms of loosening policy. The sense was that the Fed should have already been cutting rates and that it needed to cut faster than previously anticipated.

The second factor was the unwind of the so-called "yen carry trade". Basically, investors were borrowing cheaply in yen and using that money to invest at a higher return in other places around the world. When the yen appreciated, it made it harder to pay those loans back in yen and investors had to sell off assets around the globe, depressing their prices. It caught people off guard.

The third factor was valuations. Valuations of credit and equities, especially in the tech space, have been stretched. There were already questions about whether valuations represented a bubble, and market uncertainty fed that sentiment.

Based on our macro outlook, we don't think the Fed is drastically behind the curve. We think the Fed has acknowledged that the next move will likely be a 25 basis point cut at its September meeting. Does it need to do 50? We'll see. But overall, we believe the economy is still in good shape.

**Q: Despite the August selloff, how are investment grade fundamentals?**

**Todd:** As Matt highlighted, the August selloff was largely a technical situation. With over 80% of S&P 500 companies having reported earnings, year-over-year earnings growth is about 11%.[4] This is pretty strong, in our view, given that we are toward the end of the cycle.

Corporate balance sheets are healthy, and liquidity is good. If we look at the financial sector, which could have systemic implications, asset quality on banks' balance sheets is still good and funding conditions are good. Consumer balance sheets are also healthy. We don't see major fundamental concerns in the marketplace.

**Q: So why has the market been interpreting bad news as bad news?**

**Matt:** One of the interesting things about the selloff was that historically, bad economic news has been good for risk assets. This is partly because the market has expected the Fed to step in and support risk assets with rate cuts – the so-called "Fed put". That is what has happened over the past couple of years. But this time the market took bad news as bad news. Despite solid macroeconomic performance, the fact is, we are at a later point in the economic cycle, where bad news is likely to be treated as such.

So, now, I think we do want good news - and I think the market will reward good news. A year ago, when we were concerned about inflation, and the reacceleration of inflation, bad news was good news because it meant that growth was slowing. But now we want good news, to support the story that the soft landing scenario can still play out. A soft landing is our base case, and we think the Fed will cut rates three times between now and the end of the year, because it has gotten inflation under control.

3. Source: Bureau of Labor Statistics, Bloomberg L.P. Data as of Aug. 2, 2024.

4. Source: Factset. Data as of Aug. 2, 2024.

**Q: So given the recent volatility, is now the right time to jump back into the investment grade market?**

**Todd:** That will depend on whether there are any fundamental problems, such as if we head into a recession. In that case, we would expect credit spreads to widen, but that is not our base case. As of now, we favor taking advantage of new issuance in the US investment grade market. New supply includes high quality deals that are around 25 to 35 basis points cheaper than they were just a short time ago. These deals are attractive to us because we favor credits that, even in a recession, will be able to survive and do well, and they are selling at a discount. So that's our playbook and we will be watching to see where volatility goes from here, as we approach the Fed's key rate decision in September.

**Q: The US 10-year Treasury yield has declined to around 3.85%, which is below where we started the year. Do you think the move in rates has gone too far?**

**Matt:** We believe inflation will continue to slow through the rest of this year and into next year. As we mentioned, we think that will allow the Fed to cut rates three times between now and the end of the year, but we expect it to be very data dependent. I don't think the Fed will hesitate to cut more aggressively if it needs to. Our base case of three Fed rate cuts is starting to be priced into the market.

But we also think that once central banks start to cut rates, they typically don't stop until they are close to their terminal rate. So, as we near the start of the Fed rate cutting cycle, we expect more rate cuts to follow, and we expect to see yield curves normalize. The US yield curve is still slightly inverted. We expect the front end of the curve to move lower, and ultimately longer-term rates could follow it lower as well.

Overall, we are excited about the opportunities in credit going forward, and fixed income in general. We believe we could end up with high single digit returns for the year, if things continue to play out as we expect, i.e. our base case of a soft landing. And we think that's attractive.

Yes, yields have come in. But they are still significantly more attractive than they have been for the last several years. So, overall, we believe we are still in a positive environment for fixed income.

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Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

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The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.